No. 15076

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

RANDALL FOUNDATION, INC.,

Appellant,

vs.

ROBERT A. RIDDELL, DIRECTOR OF INTERNAL REVENUE, DISTRICT OF LOS ANGELES,

Appellee.

APPELLANT'S REPLY BRIEF.

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Statement of the Facts.

The primary or evidential facts stated by Appellee are substantially correct though incomplete. However, Appellee repeats therein the erroneous findings of fact objected to in the Specification of Errors in Appellant's Opening Brief that trading in securities and receiving dividends were taxpayer's *only* activities during its first year of existence and that *no* charitable activity was directly carried on during its second fiscal year. It also repeats as facts the erroneous legal conclusions set forth in the findings of fact that taxpayer was not organized or operated exclusively for charitable purposes during the fiscal years ended April 30, 1951 and April 30, 1952 and that taxpayer was operated for the primary purpose of carrying on a trade or business for profit in those years.

A. An Appellate Court May Freely Substitute Its Judgment for That of the Trial Court on Questions of Law, Mixed Questions of Law and Fact and in Determining the Legal Significance of the Primary Facts. Where, as Here, the Primary Facts Are Undisputed, This Court May Substitute Its Judgment for That of the Trial Court Regardless of Whether the Trial Court Denominated Its Conclusions as Findings of Fact or Conclusions of Law.

Appellee suggests at page 12 of its Brief that this Court's review of the Trial Court's findings of fact is limited to a determination of whether they are supported by the evidence. Such a rule has no applicability to the present case.

As Appellee itself stated in its trial Brief [Def.'s Tr. Br. 3], the facts in this case are largely undisputed. The principal facts were stipulated [R. 44-104] and the evidence submitted at the trial consisted of uncontroverted testimony explaining and clarifying these stipulated facts [R. 125, *et seq.*]. The Trial Court determined on the basis of these undisputed facts that taxpayer was not organized and operated for charitable purposes within the meaning of Section 101(6) and was operated primarily for the purpose of carrying on a trade or business for profit. This conclusion was stated both as a finding of fact and a conclusion of law. But, however denominated, it is apparent from any consideration of the record and of the questions discussed in the briefs before this Court, that the sole question decided by the Trial Court and presented on this appeal is whether on the basis of the undisputed primary or evidentiary facts, Appellant is entitled to exemption under Internal Revenue Code Section 101(6) in the light of the Revenue Act of 1950.

Under these circumstances, this Court may freely substitute its judgment for that of the court below.

Bogardus v. Commissioner of Int. Rev. (1937), 302 U. S. 34.

"The Board of Tax Appeals concluded that, from a careful consideration of all the evidence, 'the payments made by Unopco to the petitioners and others were additional compensation in consideration of services rendered to Universal and were not tax-free gifts.' This, as we recently have pointed out, is 'a conclusion of law or at least a determination of a mixed question of law and fact. It is to be distinguished from the findings of primary, evidentiary or circumstantial facts. It is subject to judicial review and, on such review, the court may substitute its judgment for that of the board.' Helvering v. Tex-Penn Oil Co., 300 U. S. 481, 491, 81 L. ed. 755, 762, 57 S. Ct. 569; Helvering v. Rankin, 295 U. S. 123, 131, 79 L. ed. 1343, 1349, 55 S. Ct. 732. * * *"

Bogardus v. Commissioner of Int. Rev., 302 U. S. 34, 38;

Exmoor Country Club v. United States (7th Cir., 1941), 119 F. 2d 961;

Kwikset Locks v. Hillgren (9th Cir., 1954), 210 F. 2d 483, cert. den. 347 U. S. 989, *cert. den.* 348 U. S. 855;

Kemart Corp. v. Printing Arts Research Laboratories (9th Cir., 1953), 201 F. 2d 624;

Kaufmann v. Commissioner of Internal Revenue (3rd Cir., 1930), 44 F. 2d 144;

Offutt v. United States (1954), 348 U. S. 11, 99 L. Ed. 11.

B. Appellant Had No Unrelated Business Income as Defined in Supplement U. The Revenue Act of 1950 Therefore Prohibits Denial of Its Exemption on the Grounds That It Was Carrying on a Trade or Business for a Profit.

Appellant's Opening Brief stressed the importance of Section 302(a) of the Revenue Act of 1950. This section provides:

> ". . . For any taxable year beginning prior to January 1, 1951, no organization shall be denied exemption under paragraph * * * (6) * * * of section 101 of the Internal Revenue Code on the grounds that it is carrying on a trade or business for profit if the income from such trade or business would not be taxable as unrelated business income under the provisions of Supplement U of the Internal Revenue Code, as amended by this Act, or if such trade or business is the rental by such organization of its real property (including personal property leased with the real property)."

Thus, even assuming contrary to the fact, that taxpayer could be said to be engaged in the trade or business of buying and selling securities for a profit by reason of its securities transactions, Section 302(a) specifically prevents denial of its exemption on this ground. Section 302(a) is expressly applicable to Appellant's fiscal year ended April 30, 1951 and, as was discussed in Appellant's Opening Brief, other provisions of the 1950 Revenue Act impliedly require the same result for subsequent years [App.'s Op. Br. 28, *et seq.*]. Appellee's only answer to this clear statutory mandate is to argue that Appellant cannot qualify under Section 302(a) because it had unrelated business income as defined by Supplement U

(Sections 421 *et seq.* of the 1939 Internal Revenue Code as amended by the Revenue Act of 1950) [Appellee's Br. 23-24].

A careful examination of Section 422 clearly shows that Appellant had no unrelated business income because of two separate and independent provisions:

(1) Section 422(a) defines unrelated business net income as being income from an unrelated trade or business with certain specified exceptions. Section 422(b) defines unrelated trade or business and, in doing so, expressly excludes any trade or business

> "in which substantially all the work in carrying on such trade or business is performed for the organization without compensation."

Appellee suggests [Tr. Br. 24] that taxpayer may not qualify under this section because it has not shown that it was not charged commissions by brokers for purchasing and selling securities nor interest on moneys borrowed. Appellee need not have stated this in the negative since the record affirmatively shows, and Appellant concedes, that normal brokerage commissions and interest were paid. Though these items may be considered expenses of the business, they certainly cannot be considered compensation for *work* performed in carrying on the trade or business. The brokerage houses involved were independent contractors, paid a regular brokerage commission and not employees of Appellant.

It would require an unwarrantedly broad construction of Section 422(b) to include such brokerage commissions as compensation for work performed in carrying on Appellant's trade or business. It would require an even more unique construction to also include interest paid on money borrowed as compensation for work performed.

However, even were the statute so construed, it is apparent from the record that *substantially* all of the work performed in carrying on Appellant's stock market activities was performed by Mr. Randall. He was not compensated for his services. Compensation to other persons would therefore not prevent exemption under Section 422(b). Moreover, even if Appellant's exemption on this ground were completely ignored, there is an independent ground which clearly prevents it from having unrelated business income.

(2) Section 422(a) specifically provides in defining unrelated business income that:

> "(1) There shall be excluded all dividends, interest, and annuities, and all deductions directly connected with such income.
>
> * * * * * * * *
>
> "(5) There shall be excluded all gains or losses from the sale, exchange, or other disposition of property other than (A) stock in trade or other property of a kind which would properly be includible in inventory if on hand at the close of the taxable year, or (B) property held primarily for sale to customers in the ordinary course of the trade or business. * * *"

All of Appellant's income fell in one of these two excluded categories. This seemed so clear that Appellant did not discuss this issue further in its Opening Brief. However, Appellee has now suggested that the inclusion of capital gains under Section 422(a)(5) is limited to

only certain capital gains and was not intended to include gains from the speculative transactions engaged in by taxpayer "particularly where taxpayer's securities were shown to have been held primarily for sale to customers in the ordinary course of taxpayer's activities." The only authority cited is the Senate Committee Report to Section 422.

Appellant has carefully studied both the House and Senate Committee Reports to the 1950 Revenue Act. It could find nothing there or elsewhere to even remotely suggest that Section 422(a)(5) was intended to exclude some capital gains and not others. On the contrary, it seems abundantly clear that Section 422(a)(5) was intended to exclude *all* capital gains. As quoted above, Section 422(a)(5) excludes gains and losses from the sale or exchange of property other than

> ". . . (A) stock in trade or other property of a kind which would properly be includible in inventory if on hand at the close of the taxable year, or (B) property held primarily for sale to customers in the ordinary course of the trade or business. * * *"

The quoted portion of Section 422(a)(5) is taken verbatim from Section 117(a) of the 1939 Internal Revenue Code defining capital gains and losses. Long before the 1950 Revenue Act, this language had acquired a well-known and specific meaning. It has been consistently held (in decisions formally acquiesced in by the Commissioner) under Section 117(a) that regardless of the type of stocks bought and sold, the length of time they are held or the

volume of purchases and sales made, gains from sales of securities held for one's own account are capital gains. The only sales of securities not so qualifying as property other than of "stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business" are sales by *dealers* of securities which they acquired to sell *to their customers* rather than for their own account.

Pacific Affiliate, Inc. (1952), 18 T. C. 1175 at 1212 (Acq. C. B. 1953-19,1);

George R. Kemon (1951), 16 T. C. 1026;

Carl Marks & Co. (1949), 12 T. C. 1196;

I. T. 3891, 1948-1, C. B. 69.

Appellee concedes, as it must, that Appellant is not a dealer in securities [Appellee's Br. 5]. It thereby necessarily concedes that Appellant's sales of securities were of property other than "stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business" as that phrase is used in Section 117(a). Appellant submits that there is no basis for giving the quoted phrase a different meaning when used in Section 422(a)(5). All of Appellant's income is therefore excluded from unrelated business income under either Section 422(a)(1) or (5).

C. Appellant Was Organized and Operated Exclusively for Charitable Purposes Within the Meaning of Section 101(6) of the 1939 Internal Revenue Code.

Appellant set forth in its Opening Brief the reasons and authorities which establish that it was organized and operated for charitable purposes within the meaning of Section 101(6) of the 1939 Internal Revenue Code. It also set forth the reasons why, even apart from the 1950 amendments, its purchases and sales of securities were not activities of a type which would warrant denial of exemption on the ground that Appellant was not exclusively operated for the charitable purposes for which organized. No useful purpose could be served by reiterating the points there made under the guise of rebuttal argument. Appellant will therefore restrict itself to a few brief comments on the new matters raised in Appellee's Brief.

1. At pages 14 and 15 Appellee suggests that Appellant cannot qualify for exemption because its original Articles and By-Laws did not require its funds to be dedicated to a specific charitable purpose at a specific time. Appellant does not, and cannot, deny that Appellant's original Articles and By-Laws unequivocally and unconditionally dedicated all of taxpayer's assets to general charitable purposes and that Appellant's primary purpose has always been to establish a home for underprivileged boys. No previous case has suggested that it was not sufficient to thus irrevocably dedicate an organization's assets to general charitable purposes and Appellant submits that any stricter rule would be both unwarranted and undesirable.

2. It is interesting to note that the only cases cited by Appellee to support its conclusion that Appellant was engaged in conducting an investment business for a profit and hence not operated exclusively for charitable purposes was the decision of the Sixth Circuit in *Kales v. Commissioner of Internal Revenue* (6th Cir., 1939), 101 F. 2d 35, 39 and the decision of this Court in *Miller v. Commissioner of Internal Revenue* (9th Cir., 1939), 102 F. 2d 476 [Appellee's Br. 18]. These were part of a long line of cases in which the Commissioner of Internal Revenue took the position that no matter how extensive taxpayer's activities were, purchases and sales of securities for ones own account could *not* qualify as a trade or business for purposes of allowing deduction of the expenses related thereto. The *Kales* case was one of the few which rejected this and held for the taxpayer. The *Miller* case distinguished *Kales* and refused to allow deductibility. The United States Supreme Court granted certiorari in *Higgins v. Commissioner of Internal Revenue* (1941), 312 U. S. 212 because of the conflict between the *Kales* decision and those in other circuits. It held that no matter how extensive the taxpayers activities it could not, as a matter of law, determine that he was engaged in a trade or business. (Congress thereafter amended the statute to allow deductibility of expenses for production of income even though taxpayer was not engaged in a trade or business.) It is only fair to add that even though the *Higgins* case is favorable, Appellant does not feel that this is the crucial point before this

Court. It is, of course, significant that Appellant was not in the trade or business of buying and selling securities. But the factor of prime importance is that its purchases and sales of securities were an activity which in no way prevented the dominance of its charitable purposes. Purchases and sales of stocks and bonds (as contrasted with conducting a commercial trade or business) is merely a means of obtaining funds for an organization's charitable purposes and is in no way inconsistent therewith. A charitable organization must raise funds as well as spend them. Exemption can properly be denied only where the organization engages in business activities which by their nature are permanent commercial activities of a type unrelated to and not properly subordinate to the organization's charitable purposes. In contrast to such business activities, purchases and sales of stocks and bonds are an investment activity which has long been recognized as a proper activity for charitable organizations. The volume of purchases and sales does not change its basic investment nature. This is affirmed by Section 422 of the 1939 Internal Revenue Code which excludes such income from the definition of unrelated business income, and hence from tax under the 1950 amendments, regardless of the volume of sales as long as the seller is not a dealer in securities selling to his customers.

D. The Decisions of This Court in the Eaton and Danz Cases Do Not Control the Present Case.

Appellee has cited virtually no relevant cases other than *Eaton and Danz.* It has quoted at length from the *Danz* opinion though it is appropriate to note that all of its quotations were from portions of the opinion dealing with obtaining a charitable deduction for funds "permanently set aside" for charitable purposes and were not applied by this Court to its discussion of whether the trust should be exempt. It is apparent that both Appellee and the court below feel that the *Danz* and *Eaton* decisions control the present case. Appellant feels that they clearly do not and hence has again set forth below, in the light of Appellee's Brief, the basic reasons why the *Eaton* and *Danz* cases do not, and cannot, control this decision.

1. *The Revenue Act of 1950:* Both cases involved tax years prior to the effective date of the Revenue Act of 1950. The applicability of Section 302(a) of the Revenue Act of 1950 was not discussed in either the *Danz* case or the *Eaton* case. We doubt if it was even raised since it seems apparent that both the Eaton Foundation and the Danz Trust had unrelated business income from their commercial activities and could not have qualified under Section 302(a). There was therefore no statutory bar to denying exemption to them by reason of the commercial trades and business in which they were engaged.

Appellant, on the other hand, had no unrelated business income. Thus by express statutory mandate Appellant is entitled to exemption for its fiscal year ended April 30. 1951 whether or not this Court would otherwise have concluded that its purchases and sales of securities would have prevented it from being operated exclusively for

charitable purposes. The Commitee Reports discussed at page 32 in Appellant's Opening Brief show that Congress intended the same rule to apply in subsequent years. As stated in the conclusion to Appellant's Opening Brief, it is this Congressional intent which clearly controls the present case.

2. *Internal Revenue Code, Section 101(6):* Completely apart from the reasons discussed in 1, Appellant's case clearly differs in crucial respects from the *Eaton* and *Danz* cases so that even without the aid of the Revenue Act of 1950 it would be entitled to exemption.

Section 101(6) requires that an organization must be "operated exclusively for . . . charitable . . . purposes." The three factors essential to the determination in the *Eaton* and *Danz* cases that those organizations were not operated exclusively for charitable purposes were:

a. They operated commercial activities such as farming, selling sports clothes, and operating a construction business, candy shops and a hotel.

b. They never intended to themselves engage in any charitable activities except indirectly by their gifts to other charitable organizations.

c. They were in competition with taxpaying business.

This Court wisely restricted its opinions to the specific situations before it and gave no indication of the rules which should be applied to other situations. Yet Appellee in its Opening Brief, by choosing isolated phrases from this Court's opinions in those cases, attempts to establish a *general* rule that an organization must function directly as a charitable organization by dispensing directly charitable

benefits in order to qualify under Section 101(6); that indirectly functioning by making gifts to other charities which in turn directly dispense charitable benefits is not enough.

There are so many thousands of charitable organizations in existence in this country today which have been granted exemption and which only function in this indirect manner that it is proper for this Court to take judicial notice of that fact. Furthermore, as stated on page 17 of Appellant's Opening Brief, the Bureau of Internal Revenue in 1924 specifically ruled that such indirect activity was sufficient, and this ruling has never since been overruled or questioned. These facts eloquently refute the general rule claimed by Appellee.

But beyond this, the present case involves a foundation organized and operated to itself conduct charitable activities and not merely to supply funds with which other organizations might do so. It did not compete with tax-paying business and did not engage in commercial activities. It has been denied exemption solely because the principal charitable objective selected required an accumulation of from two to four years before it could be fulfilled and because it actively bought and sold stocks to help accumulate funds for its charitable objective. Appellant earnestly submits that unlike the activities in the *Eaton* and *Danz* cases, the activities engaged in by Appellant did not make it any the less operated exclusively for charitable purposes as required by Section 101(6) of the 1939 Internal Revenue Code.

Respectfully submitted,

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